Policy Briefing

Briefing on the Canadian Mortgage Finance System

By Professor Jane Londerville

The mortgage finance system in Canada is quite strong, as evidenced by its performance during the recent financial crisis. Home buyers who cannot make a 20 percent down-payment are required to insure their mortgages against default. The government provides a further guarantee against a default on that insurance both for the Canada Mortgage and Housing Corporation (CMHC, 100 percent guarantee) and for the two private companies that currently offer mortgage insurance in Canada – Genworth Financial Canada and Canada Guarantee (90 percent guarantee). As a result of this guarantee, the government is able to enforce strict criteria that borrowers must meet to qualify for their loans. This system protects lenders, borrowers, and taxpayers from unreasonable risk. Lenders in Canada did not engage in the types of irresponsible lending that caused the crisis in the United States. The mortgage delinquency rate (mortgages 90 days or more in arrears) has been below 0.7 percent for over 20 years and below 0.5 percent since 2007.

However, a number of changes in the last few years have implications for the oversight of the mortgage market in Canada. Some changes have occurred in the financial markets. Other changes have been mandated or are being considered by the government. These could have significant implications for the performance of the mortgage finance system. Some of these may result in an improvement to financial institutions' access to capital, reducing costs for mortgages for consumers. But there are linkages among the various aspects of the mortgage finance system that must be very carefully examined and considered before changes are made in order to ensure the implications are fully understood.

A December 2011 International Monetary Fund (IMF) report on Canada suggests it is time for a review of the role of the CMHC given the expansion in its mortgage insurance portfolio and in mortgage-backed securities in Canada. The outstanding balance of residential mortgages in Canada was approximately $1 trillion as of 2010 and almost half of this amount was insured by the CMHC, as is shown in the following chart from the IMF report. In terms of the total volume of insured mortgages, the CMHC is estimated to have a 70 percent market share.

Jane Londerville is an Associate Professor of Real Estate at the University of Guelph and the author of the 2010 study *Mortgage Insurance in Canada: Basically Sound but Room for Improvement*, published by the Macdonald-Laurier Institute.

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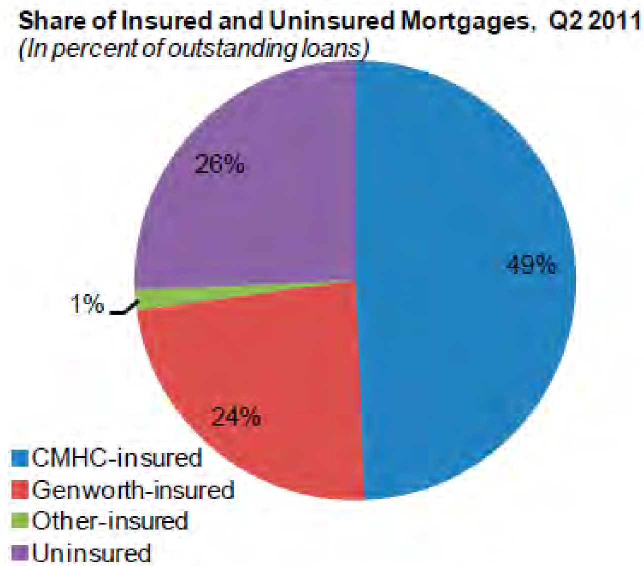
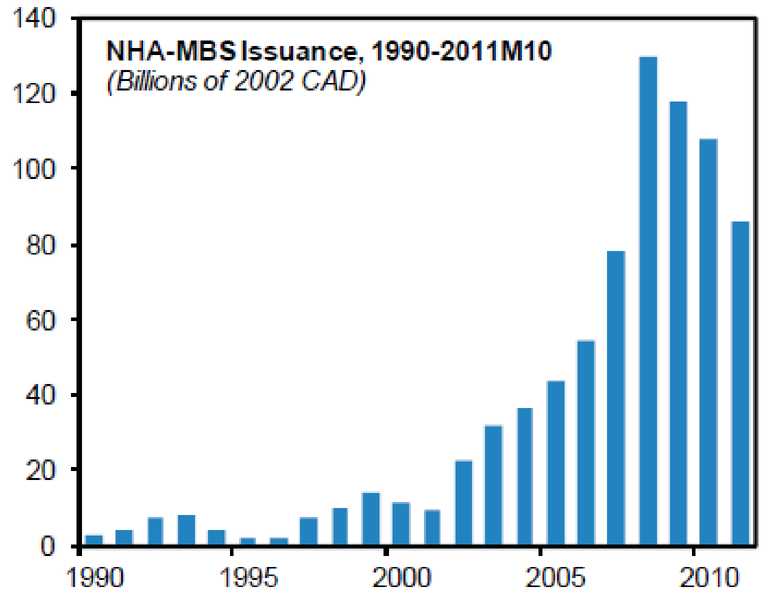


IMF Country Report No. 11/365[1]

The federal government sets a limit on the total value of mortgage loans that can be insured by the CMHC. This maximum has increased from $350B in 2007 to $450B in 2008 and is currently set at $600B. To give a sense of why the IMF has targeted the CMHC for a review, this limit is roughly equivalent to Canada's federal level of public debt, and by virtue of the fact that the CMHC is a Crown corporation, the debt is 100 percent backed by the federal government.

As a result of this rapid increase in activity, the CMHC is now substantially larger than Canada's 6th largest bank. The CMHC is subject to a comprehensive legislative framework, and reports to the federal government through the Minister of Human Resources and Skills Development. However, it is not overseen by the Office of the Superintendent of Financial Institutions (OSFI) as the banks are, and given its role in the financial sector this is certainly something any review of the Crown Corporation should consider. There is no immediate concern that the CMHC is in any sort of trouble financially. They currently hold more than 200 percent of the minimal capital requirements set by OSFI and financial reporting by the CMHC has increased in the last year (commensurate with the reporting that has always been required of private insurers).

The CMHC recently indicated to lenders that it is close to reaching its $600B insurance limit and it has chosen to ration portfolio insurance. Portfolio insurance is sought by financial institutions to allow them to sell mortgage loans into mortgage backed security (MBS) pools or covered bonds to raise additional capital. The table below shows the increase in MBS issuances since the financial crisis as banks use them to increase their capital. The level of demand for insurance on loans with greater than 20 percent equity in the homes was unanticipated by the CMHC. While not required, by obtaining insurance on these loans the lender has lower capital reserve requirements and pools of the loans are much easier to sell internationally. The implications of prohibiting insuring loans with a loan-to-value ratio less than 80 percent could be part of a review of the finance system. These loans have a very low default rate since the borrowers have a large stake in the property; it is possible they should be accounted for separately in mortgage insurers' pools of insured loans.



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The federal government issued a discussion paper in 2011 asking for feedback on proposed legislation related to covered bonds issued by financial institutions. Australia and the United States are also working toward legislation in this area. Covered bonds are issued by a bank in a way similar to the issuing of corporate bonds except that they are secured by a specific set of segregated assets. If the financial institution defaults on the bond payments, the bond holder has first claim on the assets securing the bond, over other creditors. They have been used in some European countries for centuries. They provide a further source of capital for financial institutions and are particularly valuable when capital is tight, as in recent years. The use of covered bonds in Canada has only been allowed since 2007 but the current outstanding amount has grown rapidly to over $30B. The amount is currently restricted to 4 percent of a bank's assets and only mortgages have been used as the collateral for these loans.

One suggestion that has been made is that banks not be permitted to use insured loans as security in covered bonds. This would reduce the pressure to insure loans with more than 20 percent down payments. However, it would reduce the market for these bonds since certain investors in other countries would not be permitted to buy bonds not backed by insured mortgages.

The pressure would also be eased somewhat on the CMHC if private insurers had the same backing as the Crown Corporation. When banks chose mortgage insurance providers during the financial crisis, the government's 90 percent backing of private insurers versus the 100 percent backing of the CMHC made a difference. The CMHC continued to add insurance in force with no discernable change through 2007 while Genworth suffered a decline in business.

The CMHC states that "CMHC is the only insurer of large multi-unit rental properties...and a significant percentage of CMHC's insured high-ratio homeowner loans is in rural areas and smaller communities that are traditionally not as well served by private insurers. Together these market segments made up more than 44 percent of the mortgage loan insurance underwritten by CMHC in 2010."[2] They then make the argument that this justifies the 10 percent lower guarantee for private insurers.

This argument has been made by the CMHC a number of times and raises some issues. Private insurers are not legally permitted to insure multi-family buildings. To include this in the 44 percent seems to be comparing apples and oranges. Either this market should be opened to the private sector or these loans should be excluded in all comparisons. This is an entirely different type of business from insuring single family properties and should be treated separately in CMHC statistics.

The argument that the CMHC insures in smaller communities and rural areas "not as well served by private insurers" needs to be supported with some hard data. There is no indication that private insurers are able to "cherry pick" what they insure. Lenders would presumably stop sending business their way if they refused to insure certain loans. The data exists to evaluate whether the geographic dispersion of the CMHC's loans differs from those of their private sector competitors to throw light on the accuracy of this statement. This analysis should be done to test whether the coverage differs between public and private insurers.

The CMHC also states that it has "contributed to reducing the federal deficit by some $14 billion between 2001 and 2010"[3]. This contribution comes largely from the mortgage insurance and securitization side of the CMHC's business operations. The CMHC is very proud of this payment. However, it raises some questions. Are mortgage insurance premiums too high? Should first time buyers (who are the primary users of mortgage insurance) have a greater responsibility for reducing the federal deficit than others in society? Canadians pay a flat, upfront fee for mortgage insurance if they have less than a 20 percent down-payment, calculated as a percentage of the amount borrowed.

There are different models of insurance payments used in other countries. One such model has a smaller upfront payment with a monthly payment that is in effect until the loan to value ratio drops below 80 percent; this could be less onerous for borrowers while still providing sufficient fee income to cover defaults. A more competitive mortgage insurance market with more balanced market share could potentially lead to this type of innovation.

When the mortgage meltdown in the United States started, the federal government changed lending criteria in two stages. Borrowers are now restricted to a 30-year amortization period (down from 40), they must have a 5 percent down-payment (20 percent for a rental property), and borrowers are restricted to a 90 percent loan-to-value ratio when refinancing. These criteria may now be too restrictive, impeding access to homeownership. A young household in Toronto may need a 40-year amortization period on their first home to make it affordable, for example. In the past, these loans were issued with a higher mortgage insurance fee to account for the increased risk of slower loan repayment. In certain markets and for certain age groups, perhaps with limits on the house price it applies to, 40-year amortizations may be sensible.

Despite these changes to lending criteria, no adjustments have been made to the main lending constraint for most borrowers, the maximum Total Debt Service ratio. This is the ratio of the borrower's total debt payments, including mortgage payments and property taxes, to their gross household income. This criterion has been in place for decades with little examination. There is an argument that the calculation should be based on take home pay rather than gross pay. It could be different for different income levels – 40 percent of $40,000 does not leave a lot of room for other household expenses. Young homeowners who have children in daycare can be paying a fee almost equivalent to a second mortgage payment; this is not taken into account when calculating the maximum the bank will lend because it is not defined as a debt. The United States required new low income homeowners to take a course related to managing a household budget before they were approved for a mortgage. This could be an appropriate strategy to implement in Canada.

The role of the CMHC in housing finance in Canada is very complicated and intricate; while some changes to its role may be necessary, there should first be a careful analysis of the impact of those changes. The big banks have publicly stated that the purchase of mortgage loans by the CMHC during the financial crisis was essential to maintaining the stability of the Canadian mortgage system. The government was able to implement the purchases quickly because of the CMHC's mortgage business.

As well, there are many facets to residential mortgage insurance and finance that need to be considered; changes to one area can have an unanticipated impact on another area that may be detrimental to consumers. A careful review of the entire way in which we lend money for the purchase of homes in Canada is well timed; we have an excellent system envied around the world but this does not mean it cannot be improved.

Recommendations:

1) Given the recent financial crisis and resulting pressure on the mortgage finance system in Canada, a thorough review is advised. The Canadian mortgage finance system performed extremely well during the global crisis, so any adjustments made need to be carefully assessed to ensure they strengthen the system rather than altering it in a way that makes it less effective. This review should include an assessment of the criteria used to lend to homeowners.

2) The system of oversight and regulation of the CMHC should be carefully reviewed with a specific assessment of whether or not it should come under the regulation of the Office of Superintendent of Financial Institutions, which regulates and provides oversight of financial institutions in Canada. The CMHC now holds assets in excess of the size of Canada's 6th largest bank. In addition, the loans insured by the CMHC, which are fully backed by the Government of Canada, are now approximately the size of the federal government's net debt. Proper and adequate regulation and oversight of this Crown Corporation is essential to managing risk in the future.

3) Part of a broad review of mortgage insurance should include an assessment of whether or not financial institutions should be permitted to insure loans with a loan-to-value ratio of less than 80 percent, which do not require insurance under Canadian regulations.

4) Another aspect of mortgage financing worthy of review is whether insured loans should be eligible for use as security in covered bonds. Removing their eligibility for covered bonds would reduce the pressure on insurance limits for the CMHC and private insurers but may make covered bonds less marketable, and thus less useful, for financial institutions.

5) The argument for differential government backing of mortgage insurers between the CMHC (100 percent) and the two private companies currently serving this market (90 percent) needs to be fundamentally re-evaluated. The rationale for the difference is not clear; an

analysis of both private and publicly insured mortgages should be done to assess whether there is any disparity in the types of loans insured by the two groups.

6) The large payments made to the government by the CMHC over the last decade may indicate that pricing of mortgage insurance is above the competitive level. The review should examine mortgage insurance pricing systems in other countries to see if a more affordable fee structure would work in Canada while still providing adequate protection for financial institutions and sufficient reserves for insurers.

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[1] International Monetary Fund. 2011. Canada: Selected Issues Paper. Country Report No. 11/365. Available at http://www.imf.org/external/pubs/ft/scr/2011/cr11365.pdf.

[2] Canada Mortgage and Housing Corporation. 2011. "Housing Finance." *Canadian Housing Observer 2011*, no. 9: 20, http://www.cmhc-schl.gc.ca/en/corp/about/cahoob/upload/Chapter_2_EN_dec21_w.pdf.

[3] Canada Mortgage and Housing Corporation.2011. "Housing Finance." *Canadian Housing Observer 2011*, no. 9: 22, http://www.cmhc-schl.gc.ca/en/corp/about/cahoob/upload/Chapter_2_EN_dec21_w.pdf